LIETUVOS BANKAS
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Banking activity review
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Banking activity review

The assets of banks operating in Lithuania increased slightly in Q3 2015 quarter on quarter. Banks complied with the established capital and liquidity requirements. Lending was active for the second consecutive quarter, while the amount of customer deposits with banks increased further, despite low interest rates. The operations of the banking system were profitable in the first three quarters of 2015; however, the low interest rates environment and the shrinking income from fees and commissions led to the lowest profits since 2010. The provisions of the Bank Recovery and Resolution Directive have been transposed to Lithuanian law.

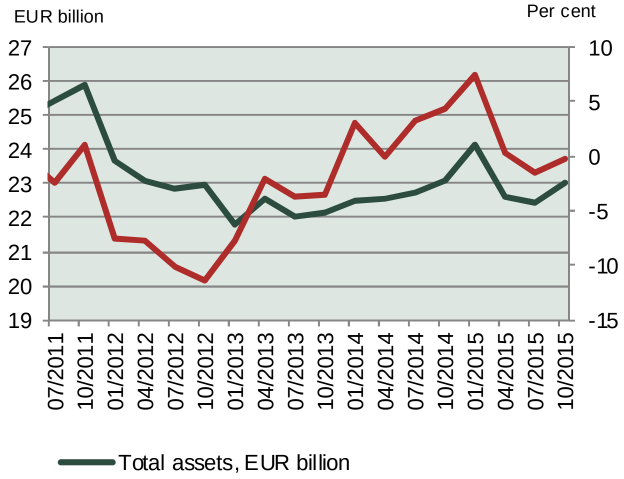
Assets and liabilities

Bank assets increased moderately during the quarter. In Q3 2015, seven banks and nine foreign bank branches operated in Lithuania, including a new branch of *Telia Sonera Finance AB* established in Lithuania, which has not started operating yet. Bank assets amounted to EUR 23.0 billion at the end of the period, an increase of EUR 631 million (2.8%) quarter on quarter. Year on year the assets of the banking system fell slightly year on year — EUR 65 million (–0.3%).

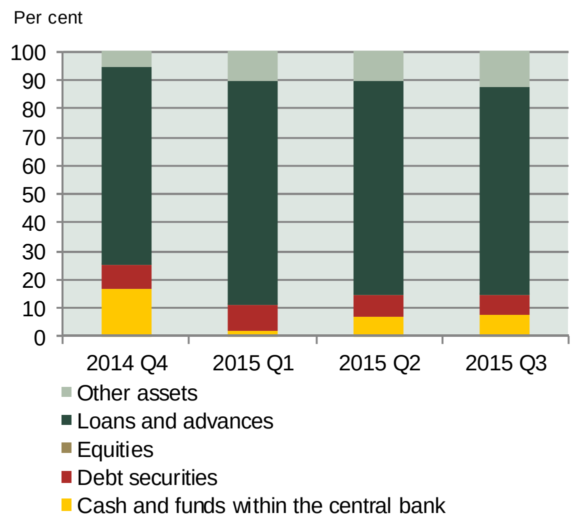
In Q3 2015, loans to customers, including leasing, fell the most quarter on quarter (EUR –107 million, or –0.7% — to EUR 16.1 billion); the Other Asset Positions item grew the most[2] (by EUR 474 million, or 86.6% — to EUR 1.0 billion). The contribution to such reallocation of asset items stemmed from the envisaged sale of the retail banking business of the *Danske Bank A/S* Lithuania branch to *Swedbank, AB*: a certain amount of loans was assigned to non-current assets and disposal groups, classified as held for sale. Having excluded the contribution of this factor, the amount of loans granted to customers *de facto*, including leasing, would have boosted by approximately EUR 373 million (2.3%) in Q3 2015.

[1] Should system participants identify significant errors in financial statements and present the statements anew, the data of the Review after this date may be revised.
[2] Of which fixed assets are assigned to assets held for sale, which grew by EUR 470 million (16.1%) — to EUR 0.5 billion.

Assets of the banking sector



Asset composition



Source: The Bank of Lithuania

The amount of debt securities contracted somewhat (by EUR –39 million, or –2.3% — to EUR 1.7 billion) quarter on quarter. In Q3, as in previous quarters, the trend to cut investment in debt securities, the yields of which are currently especially low, remained. The banks were keen to hold funds in accounts with the central bank or other credit institutions instead. The amount of funds held in the accounts with the Bank of Lithuania boosted by EUR 200 million (16.9%) — to EUR 1.4 billion, with credit institutions — by EUR 125 million (5.6%) — to EUR 2.4 billion quarter on quarter.

In Q3 2015, bank liabilities (less equity) grew by EUR 565 million (2.8%) — to EUR 20.5 billion. The growth was mainly due to an increase in other asset positions of EUR 349 million (72%). A significant share of the latter amount consists of reallocated liabilities related to the planned transaction between *Swedbank, AB* and the *Danske Bank A/S* Lithuania branch. There was also a rise in liabilities to credit institutions (mainly parent banks) by EUR 117 million (3.9%) and in the amount of customer deposits by EUR 86 million (0.5%). It should be noted that, having excluded the contribution of the above-named planned transaction, the customer deposit portfolio would have increased much more.

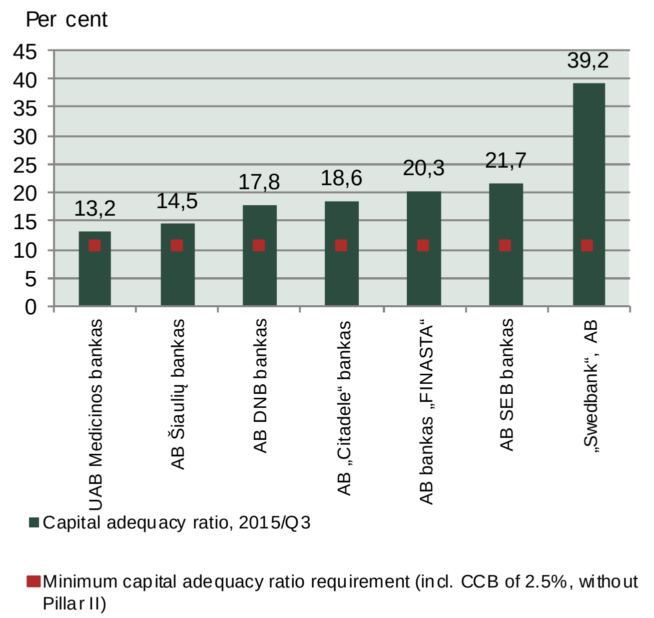
Compliance with requirements

All banks operating in Lithuania comply with both the minimum capital adequacy requirement and the new capital conservation buffer requirement with a margin. The overall capital adequacy ratio of banks, as of 1 October 2015, was 24.3 per cent, an increase from the previous quarter (23.8 %). All banks operating in Lithuania complied with both the minimum capital adequacy requirement (8.0%) and the capital adequacy requirement including the 2.5 per cent capital conservation buffer (total of 10.5%), which came into effect on 30 June 2015. The capital of the Lithuanian banking system consists mainly (98%) of the highest quality common equity Tier 1 capital (CET1); its respective ratio in Q3 2015 amounted to 23.9 per cent (the minimum requirement is 4.5%, including the capital conservation buffer of 7.0%).

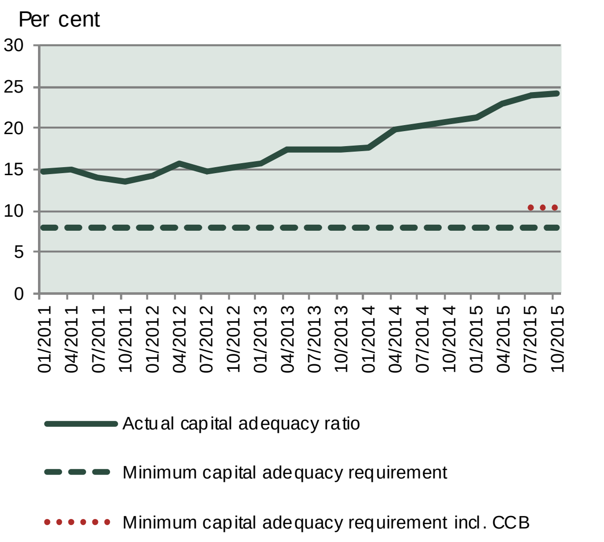
Additional capital requirements were set for banks operating in Lithuania, which the banks comply with. In observance of the European Union Capital Requirements Directive IV, implemented in Lithuania, the Bank of Lithuania conducts a Supervisory Review and Evaluation Process (SREP) on an annual basis. During the SREP, banking activity, financial standing and compliance with prudential requirements are evaluated; in addition, the requirement of additional capital, necessary for covering Pillar II risks (which are not covered by the minimum capital adequacy requirements), is set. Since the supervision of the Lithuanian banking sector became part of the Single Supervisory Mechanism, the above-named decisions regarding the results of the SREP in the three largest banks — *AB SEB bankas*, *Swedbank, AB*, and *AB DNB* — are made by supervisory colleges, with the participation of the European Central Bank in close cooperation with the Bank of Lithuania. A respective decision regarding *AB Citadele bankas* is made by the supervisory college in Latvia, while with regard to *AB Šiaulių bankas* and *UAB Medicijos bankas* — by the Board of the Bank of Lithuania. On 1 October 2015, it was announced that *AB Šiaulių bankas* will have to comply with the CET1 adequacy ratio of 9 per cent and the total capital ratio of 12.5 per cent. For *UAB Medicinos bankas*, the requirements of 8.9 per cent and 12.4 per cent were established respectively. Due to ongoing restructuring and merger of the business with *AB Šiaulių bankas*, as well as the planned revocation of the licence for *AB bankas FINASTA*, the SREP was not conducted for the bank this year: it is still subject to the previously established total capital adequacy ratio of 11 per cent. Additional capital requirements for other domestic banks are currently not announced; it should be noted, however, that all banks comply with them. Despite the good state of the banking system's capital, for some banks, the issue of adequate capital reserve remains relevant; consequently, the Bank of Lithuania devotes considerable attention to the degree of risk assumed, its monitoring and assessment.

The reserve of liquid assets held by banks is in line with the established requirements. The liquidity level of banks continued to be high in Q3 2015; their liquid asset reserves were adequate. On 10 October 2014, the European Commission approved the Delegated Regulation, under which banks, as of 2015, must ensure compliance with the liquidity coverage ratio (LCR). By decision of the Board of the Bank of Lithuania, the requirement for this ratio is 100 per cent. As of 1 October 2015, the approved Delegated Regulation came into effect; its implementing Regulation, establishing specific statement forms and instructing on the completion of the forms, was also to be prepared. Upon decision by the European Commission to revise and amend the Delegated Regulation, however, the preparation of its implementing Regulation was postponed to a later date. The Bank of Lithuania, in monitoring banks' liquidity situation and seeking to be sure that banks ensure compliance with the new liquidity coverage requirements, calculates preliminary LCR indicators, using data submitted by banks. At the end of Q3 2015, all banks operating in Lithuania complied with the ratio requirement with a comfortable margin.

Capital adequacy measures of banks
(%)



The capital adequacy ratio of the banking system



Source: The Bank of Lithuania

Loan and leasing portfolio

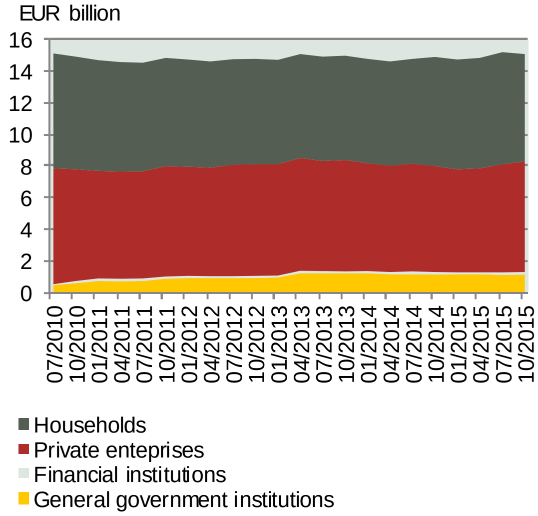
Loan and leasing portfolio developments

Bank lending intensified in Q3 2015. In this period, banks had granted to their customers EUR 107 million (–0.7%) less loans (including, here and hereafter, leasing) on a net basis[3] quarter on quarter, with their entire loan portfolio amounting to EUR 16.1 billion. However, having excluded the earlier-named effect of the planned transaction by the *Danske Bank A/S* Lithuania branch on the items of financial statements, the real loan portfolio amount was EUR 16.6 billion, which corresponds to a quarter-on-quarter increase of

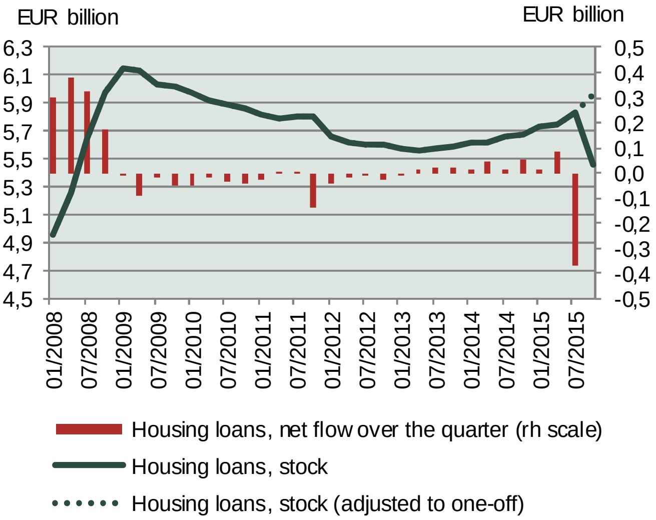
[3] Loan portfolio (on a net basis) — loans that debtors have to repay to banks, including the accrued interest on the loans less the loan impairment. It should be noted that in various Bank of Lithuania statements, several concepts of loan portfolio are used.

approximately EUR 372 million (2.3%). Year on year this loan amount grew by about EUR 698 million (4.4%).

The loan portfolio of banks



Housing loans



Source: The Bank of Lithuania.
Note: As of 1 October 2014, housing loans include loans granted to households designated for investment in one's house for one's own needs or rent, including construction and repair; consequently, the data are not fully comparable to the line of previous data.

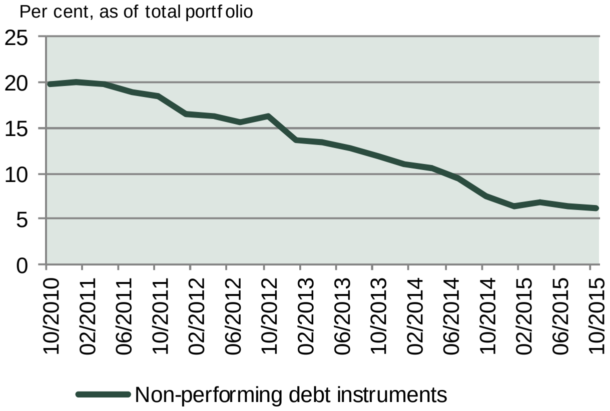
The loan market, already in Q2 2015, posted a greater-than-usual recovery, which continued into Q3: both enterprises and households borrowed more. Loans to private enterprises grew noticeably over the quarter — by EUR 196 million (2.6%); while having excluded the contribution of the planned transaction between the *Swedbank, AB* and *Danske Bank A/S* Lithuania branch, a significant increase in the portfolio of loans of households[4], mainly driven by respective changes[5] in the housing loans portfolio, would be observed. Having excluded the nominal effect of the planned transaction between the two banks on the household lending statistics, the housing loans portfolio level has reached record heights since early 2010.

Loan and leasing portfolio quality

The loan and leasing portfolio improved gradually in quality. Having excluded one-off changes in the accounting of the *Danske Bank A/S* Lithuania branch in relation to the planned transaction with *Swedbank, AB*, the ratio of the banking system's non-performing debt instruments was 6.1 per cent of the portfolio on a gross basis[6] in Q3 2015, an improvement of 0.3 p.p. over the quarter. The greatest contribution stemmed from a rise in the funds with central banks and credit institutions, as well as loan portfolio growth, driven by new loans granted.

[4] According to the estimate of the Bank of Lithuania, approximate change, excluding one-off changes in the accounting of the *Danske Bank A/S* Lithuania branch, is an increase of EUR 165 million.
[5] According to the estimate of the Bank of Lithuania, approximate change, excluding one-off changes in the accounting of the *Danske Bank A/S* Lithuania branch, is an increase of EUR 108 million.
[6] The ratio of non-performing loans in the loan portfolio (excluding funds with banks and debt securities) was 7.9 per cent.

Non-performing debt instruments

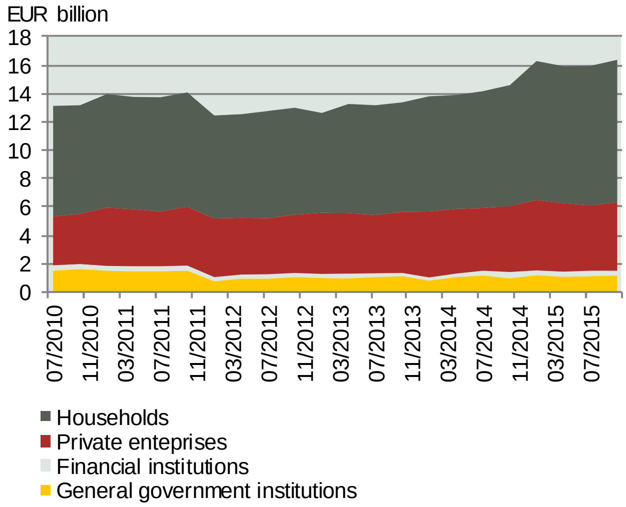


Note: from 2015 the European Union has begun applying a new definition for non-performing loans; the 1 October 2014 quality indicators for the loans of banks operating in Lithuania are announced in accordance with new requirements and their meanings are not entirely comparable to earlier ones.
Source: The Bank of Lithuania

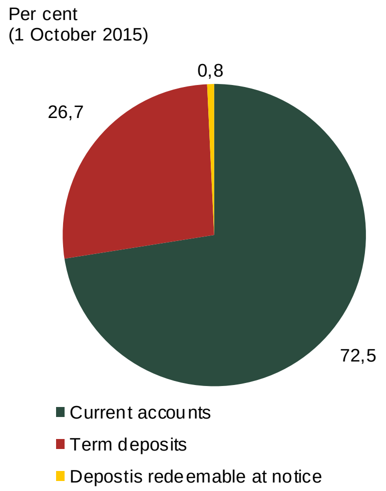
Deposits with banks

The amount of deposits with banks grew further in Q3 2015. As of 1 October 2015, customers held EUR 16.0 billion in deposits with banks, a hike of EUR 86 million (0.5%) quarter on quarter. Deposits of private enterprises grew significantly over the quarter — by EUR 231 million (5.0%); the amount of household deposits declined by EUR 143 million (–1.5%) over the same period. This change was affected by the previously-named planned transaction between the two banks, due to which part of the deposits was reclassified to liabilities to be sold. Having excluded the contribution of this transaction, the customer deposit portfolio would have grown much more.[7] Despite exclusively low interest rates, the trend of growth in deposits has remained; most of deposits are held on current accounts though, giving preference to liquidity.

The amount of deposits



Composition of deposits by term
(1 July 2015)



Source: The Bank of Lithuania

Profitability and efficiency of the activity

During the nine months of 2015 the operations of the banking system were profitable; however, total profit declined further, to be the lowest since the respective period in 2010. The profits earned by banks and foreign bank branches operating in Lithuania over the nine months of 2015 amounted to EUR 168.6 million, a year-on-year decrease of EUR 10.6 million (–5.9%). The total profit the Lithuanian banking system for three quarters, this year, was the lowest since 2010. It was negatively affected by the decrease of both net interest income and net income from fees and commissions. During the period under review, 8

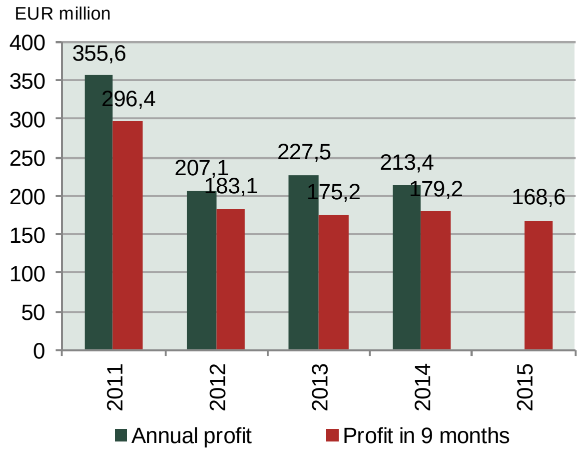
[7] According to the estimate of the Bank of Lithuania, approximate change, excluding one-off changes in the accounting of the *Danske Bank A/S* Lithuania branch, is an increase of more than EUR 250 million.

market participants improved and 7 market participants worsened their performance compared to the same period a year ago.[8] Only two market participants incurred losses, while the operations of the others were profitable.

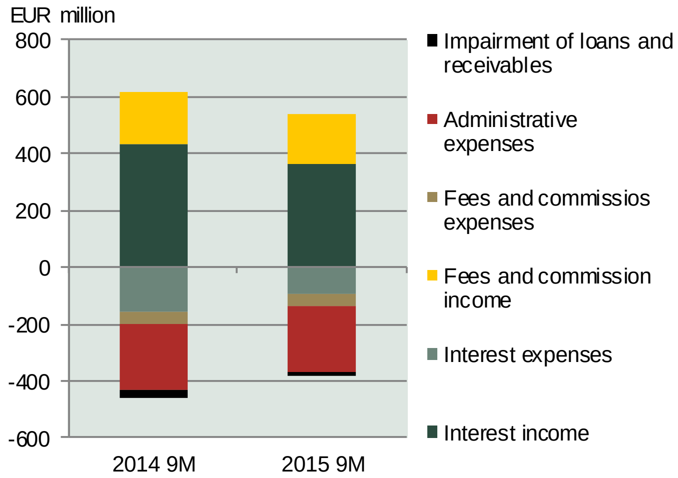
The benefits of declining interest do not offset losses from income being lost. Year on year banks' interest income contracted by EUR 68.0 million (–15.8%) over the nine months of 2015 and stood at EUR 362.8 million, whereas their expenses dropped by EUR 60.2 million (–39.0%) and amounted to EUR 94.1 million. The environment of low interest rates remained unfavourable for banks, since lower expenses did not offset the decreased income, generated from their asset holdings: the net interest income contracted by EUR 7.9 million (–2.9%) and amounted to EUR 268.6 million.

The fall in the income from fees and commissions is still driven by lost income upon the adoption of the euro. Year on year income from fees and commissions fell by EUR 10.6 million (5.7%) over the nine months of 2015, to amount to EUR 174.6 million, unlike expenses, which grew by EUR 2.3 million (5.2%) and amounted to EUR 45.7 million. Thus, net income from fees and commissions fell by 12.9 million (–9.1%) and amounted to EUR 128.9 million. Since early this year, banks have been recording a fall in income from fees and commissions. This is due mainly to the adoption of the euro, as this caused the loss of income from litas exchange into euro and cross-border transfers.

Profit of the banking sector



Main items of income and expenses

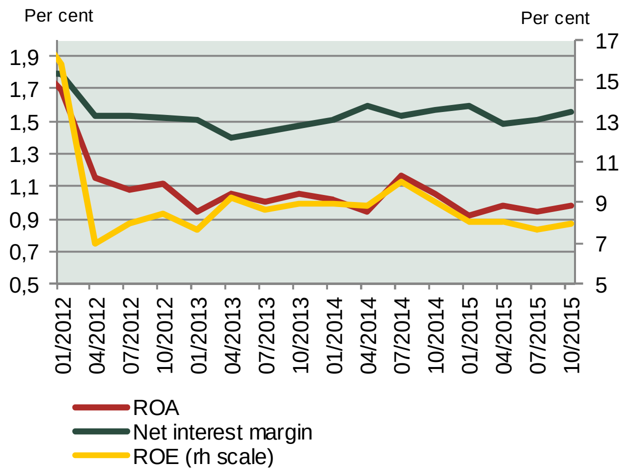


Source: The Bank of Lithuania

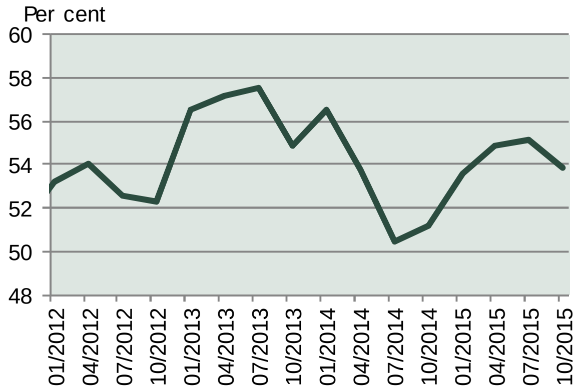
After a fairly long break, banks' administrative expenses fell, but staff costs continue to rise. Over the nine months of 2015, banks incurred EUR 231.8 million of administrative expenses. Year on year they fell by EUR 3.4 million (–1.4%) — for the first time after growth was observed for four consecutive quarters. The growth in administrative expenses in previous periods was driven by the growing expenses on wages and salaries; this effect continued into Q1–Q3 2015: banks' staff costs boosted by EUR 9.7 million. Their positive influence was, however, outweighed by a fall in other administrative costs by EUR 13.0 million. This fall was due to greater changes in several banks, which cut their information technology costs.

[8] *Telia Sonera Finance AB* Lithuania branch is not operating so far and does not submit statements to the Supervision Service of the Bank of Lithuania.

Bank profitability ratios and net interest margin



Bank cost-to-income ratio



Source: The Bank of Lithuania.

A fall in income and not contracting expenses led to the deterioration of banks' profitability indicators. Banks' return on assets ratio decreased from 1.05 per cent to 0.98 per cent over the year, while their return on equity fell from 9.00 per cent to 7.97 per cent. A decline in income and a non-decline in expenses accordingly led to a worse cost-to-income ratio value in Q3 2015, which, in this quarter, was 53.9 per cent (51.2% a year ago). The negative impact of falling interest rates does not offset benefits from cheaper liabilities. Banks' net interest margin was 1.56 per cent on 1 October 2015, a slight decrease from 1.57 per cent year on year. This inconsiderable change in the margin was due to similar changes in both the ratio of interest income and interest-generating assets (–0.41 p.p.) and the ratio of interest cost and interest-bearing liabilities (–0.40 p.p.).

The regulatory and economic environment

The _Danske Bank A/S_ Lithuania branch is going to sell its retail banking business to _Swedbank, AB._ As early as at the beginning of 2015, _Danske Bank A/S_ announced that it intended to gear its business in the Baltic States to business and private banking; on 23 September 2015 the bank announced that it was going to sell its retail banking business in Lithuania and Latvia to the subsidiaries of Sweden's _AB Swedbank._ The transaction has not taken place yet and permission from the Lithuanian Competition Council is being awaited. Once it is received, the transfer of services to _Swedbank, AB_ in Lithuania is scheduled for Q1 2016; the volume of the loan portfolio to be transferred in Lithuania is about EUR 525 million.

The provisions of the Bank Recovery and Resolution Directive have been transposed to Lithuanian law. On 19 November 2015, the Seimas approved the draft Law on Financial Sustainability and almost 20 subordinate draft laws, which transpose the provisions of the Bank Recovery and Resolution Directive to national law. Under these laws, the Bank of Lithuania is authorised as the national resolution authority. Institutions falling within the scope of the Law on Financial Sustainability (including 7 banks) will have to pay for the first time, by 31 December 2015, contributions to the national Resolution Fund according to the procedure established by the resolution authority. The funds of this Fund will, from 2016, be transferred to the single resolution fund of banking union countries, to be managed by the Single Resolution Board, which will also set the size of contributions. Once the resolution authority draws up resolution plans, banks will have to comply with the minimum equity capital and eligible liabilities requirement. These requirements will be set to each bank on an individual basis by the resolution authority. In addition, banks will be obligated to draw up recovery plans and submit them to the supervisory authority; in them, they will have to define indicators reflecting the financial status and their levels, as well as to envisage recovery measures to be taken to restore the financial status should these indicators reach their marginal values.

Banks intensively prepared for joining the electronic euro payments area from 2016. As of 1 January 2016, Lithuania is joining the Single Euro Payments Area, also called SEPA, encompassing 34 countries. In 2015, banks intensively prepared for migration to the Single Euro Payments Area, allocating substantial resources, changing their payment systems accordingly, and testing. After joining SEPA, the same payment form will be completed both for domestic payments and payments to other SEPA countries, whereas one account will be enough to execute or receive payments in any SEPA country.

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Annex: Key performance indicators of banks

Table 1. Main items of the balance sheet statement

No.	Indicator	2014-10-01	2015-07-01	2015-10-01	Q3 change Q/Q	Q3 change Y/Y
		million euro			percent	
1.	**Assets**	**23 108,4**	**22 412,5**	**23 043,7**	**2,8**	**-0,3**
1.1.	Debt securities	2 159,8	1 693,9	1 654,8	-2,3	-23,4
1.2.	Equities	37,8	46,3	45,4	-1,9	20,2
1.3.	Derivatives	210,7	140,0	134,1	-4,2	-36,4
1.4.	Cash	378,0	370,9	356,9	-3,8	-5,6
1.5.	Funds held w ith central banks	1 460,5	1 181,2	1 380,9	16,9	-5,5
1.6.	Funds held w ith credit institutions	2 160,4	2 248,8	2 373,9	5,6	9,9
1.7.	Loans to clients (incl. leasing)	15 859,5	16 184,2	16 076,8	-0,7	1,4
1.7.1.	Government institutions	1 130,6	1 121,1	1 128,2	0,6	-0,2
1.7.2.	Other financial institutions	160,3	163,5	168,3	3,0	5,0
1.7.3.	Non-financial institutions	7 568,2	7 666,8	7 863,1	2,6	3,9
1.7.4.	Households*	7 000,4	7 232,7	6 917,2	-4,4	-1,2
1.7.4.1.	Housing loans*	5 675,7	5 829,3	5 456,6	-6,4	-3,9
1.8.	Other assets	841,6	547,2	1 021,0	86,6	21,3
2.	**Liabilities and equity**	**23 108,4**	**22 412,5**	**23 043,7**	**2,8**	**-0,3**
2.1.	Central bank deposits	0,0	345,8	360,8	4,4	2254962,5
2.2.	Liabilities to credit institutions	5 366,7	3 018,5	3 135,2	3,9	-41,6
2.3.	Derivatives	197,4	122,8	123,1	0,3	-37,6
2.4.	Depostis*	14 568,9	15 941,7	16 027,4	0,5	10,0
2.4.1.	Government institutions	946,8	1 101,4	1 146,2	4,1	21,1
2.4.2.	Other financial institutions	456,3	376,2	329,4	-12,4	-27,8
2.4.3.	Non-financial institutions	4 637,5	4 610,3	4 840,9	5,0	4,4
2.4.4.	Households*	8 528,3	9 853,8	9 710,9	-1,5	13,9
2.5.	Issued debt securities	95,6	38,9	37,2	-4,3	-61,0
2.6.	Other liabilities	421,3	486,2	835,2	71,8	98,2
2.7.	Equity	2 458,7	2 458,6	2 524,8	2,7	2,7

Source: The Bank of Lithuania.

** On 1 October 2015, due to one-off changes in accounting, related to the envisaged sale of the retail business of the Danske Bank A/S Lithuania branch, part of household deposits and loans (including housing loans) were entered as liabilities and assets to be sold. Consequently, the actual amounts of household deposits and loans contracted by respective values. For more comments, see the text of the Review.*

Table 2. Main items of the profit (loss) account

No.	Indicator	2014-10-01	2015-07-01	2015-10-01	Q3 change Q/Q	Q3 change Y/Y
		million euro			percent	
3.	**Profit**	**179,2**	**109,2**	**168,6**	_	**-5,9**
3.1.	Net interest income	276,5	176,2	268,6	_	-2,9
3.2.	Net fees and commission income	141,8	83,3	128,9	_	-9,1
3.3.	Administrative expenses	235,1	155,4	231,8	_	-1,4
3.4.	Impairment of loans and receivables	33,8	10,5	20,4	_	-39,5

Source: The Bank of Lithuania.

Table 3. Other indicators

No.	Indicator	2014-10-01	2015-07-01	2015-10-01	Q3 change Q/Q	Q3 change Y/Y
		percent			percentage points	
4.	Capital adequacy ratio	20,7	23,8	24,3	0,5	3,6
5.	CET1 capital adequacy ratio	20,3	23,4	23,9	0,5	3,6
6.	Net interest margin	1,57	1,51	1,56	0,1	0,0
7.	Return on assets	1,05	0,95	0,98	0,0	-0,1
8.	Return on equity	9,00	7,63	7,97	0,3	-1,0
9.	Cost-to-income ratio	51,2	55,2	53,9	-1,3	2,7
10.	Non-performing debt instruments (as of total portfolio)**	7,5	6,4	5,7	-0,7	-1,8
11.	Non-performing loans (excl. funds w ith banks and debt securities) (as of total portfolio)***	9,0	8,2	7,5	-0,7	-1,6

Source: The Bank of Lithuania.

***Having excluded the contribution of one-off changes in the accounting of* the *Danske Bank A/S Lithuania branch, the value of the indicator was 6.1 per cent on 1 October 2015.*

**** Having excluded the contribution of one-off changes in the accounting of* the *Danske Bank A/S Lithuania branch, the value of the indicator was 7.9 per cent on 1 October 2015.*